No. 22,751

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

DON R. THOMPSON and MILDRED THOMPSON,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court was correct in holding that the taxpayers are not entitled to an investment credit, under Sections 38 and 46 of the Internal Revenue Code of 1954, on the reacquisition and use of depreciable assets, which they had previously owned and used, which they had sold on April 2, 1962, and, which they had reacquired through foreclosure proceedings on April 4, 1963.

STATEMENT OF THE CASE

This appeal involves federal income taxes for the taxable year 1963 in the amount of $2,164.01, plus interest. (I-R. 113.) The Commissioner mailed a notice of deficiency to the taxpayers on December 8, 1965. (I-R. 5.) On February 28, 1966, the taxpayers filed a petition for redetermination of the deficiency with the Tax Court. (I-R. 1-13.) The Tax Court entered its decision on February 5, 1968, sustaining the Commissioner's deficiency determinat with respect to the issue on appeal, but determined overpayments as to agreed adjustments. (I-R. 109-110.) On February 19, 1968, the taxpayers filed, with the Clerk of the Tax Court, a petition for review of the Tax Court's decision by the United States Court of Appeals for the Ninth Circuit. (I-R. 111-114.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts relevant to this petition for review, found by the Tax Court (I-R. 94-96), some of which were stipulated (I-R. 20-92), are as follows:

Taxpayers, Don R. Thompson and Mildred Thompson, are husband and wife, whose legal residence was Tucson, Arizona, at the time the filed their petition for redetermination of the deficiency with the Tax Court. They filed joint federal income tax returns for the calendar year 1963 with the District Director of Internal Revenue at Phoenix, Arizona. (I-R. 95.)

On December 4, 1957, taxpayers entered into a lease agreement with the owners of certain premises located in Tucson, Arizona, for a period of over eight years. Shortly, thereafter, taxpayers began conducting, on these premises, a business known as Redwood Lodge. (I-R. 95.)

On April 2, 1962, taxpayers sold the business known as Redwood Lodge, including all personal property used in connection therewith, to Redwood Gay Nineties Lodge, a corporation. To secure a portion of the purchase price, a note and chattel mortgage were given to taxpayers. (I-R. 95.)

The purchasers failed to make payments on the note, and on April 4, 1963, just one year after the sale, the mortgage was foreclosed. (I-R. 95.)

Neither the Redwood Gay Nineties Lodge Corporation nor its shareholders were related to taxpayers within the meaning of either Section 267 or 707(b) of the Internal Revenue Code of 1954. (I-R. 95.)

As a result of the foreclosure by taxpayers, they reacquired $46,371.71 of tangible personal property with a useful life of seven years. This property was the very same personal property which they had owned and used in connection with their business prior to the aforementioned sale of April 2, 1962. (I-R. 95-96.) All of the reacquired property was also originally purchased by taxpayers prior to January 1, 1962, the date on which the investment credit became effective. (I-R. 101.)

Taxpayers began using the reacquired property again in 1963 (I-R. 95), and they claimed an investment credit in connection with the reacquisition of such property on their 1963 tax return (I-R. 24-37).

The Commissioner, in his deficiency notice of December 8, 1965, determined that none of the assets acquired in connection with the repossession of the Redwood Lodge qualified for an investment credit under Section 38, et seq., of the Internal Revenue Code. (I-R. 8.)

The Tax Court sustained the Commissioner's position. (I-R. 101.)

SUMMARY OF ARGUMENT

The Tax Court's holding that taxpayers are not entitled to an investment credit in the present situation, based on the plain and unambiguous language of Section 48(c)(1) of the Internal Revenue Code, is correct. This section of the Code expressly denies the investment credit to a taxpayer who acquires property and then permits it to be used by a person who used the property before taxpayer acquired it. Taxpayers in the present situation used the $46,371.71 of assets before the 1963 acquisition through foreclosure, from 1957 to 1962. They were also the ones using the property after the acquisition in 1963. They thus come fully within the exclusionary language of Section 48(c)(1).

Contrary to taxpayers' arguments, the legislative history and the Regulations promulgated under Section 48(c)(1) do not conflict with the Commissioner's position. The Regulations merely repeat the language of the statute. The legislative history indicates that Section 48(c)(1) was enacted "to prevent abuse" of the investment

credit. The present situation would, in fact, result in an abuse of the investment credit in several ways if taxpayers' contentions are upheld. For example, the credit, which was enacted to encourage investment in newly acquired assets after 1961, could be availed of by taxpayers, who invested no additional funds in the property after 1957. The Tax Court's opinion should therefore be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY HELD THAT TAXPAYERS ARE NOT ENTITLED TO AN INVESTMENT CREDIT ON THE REACQUISITION AND USE OF ASSETS, PREVIOUSLY ACQUIRED BY THEM IN 1957 AND SOLD IN 1962, AND REACQUIRED THROUGH FORECLOSURE PROCEEDINGS IN 1963

A. Under the clear and unambiguous language of the statute, the reacquired property does not qualify for an investment credit

The sole issue presented for review is whether the $46,371.71 of personal property reacquired by the taxpayers in 1963 qualifies for an investment credit. (I-R. 112.) In 1962, "to encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country," Sections 38 and 46 through 48, all Appendix, infra, granting an investment credit for certain depreciable property acquired or constructed by a taxpayer, were added to the Internal Revenue Code of 1954 by Section 2 of the Revenue Act of 1962, P.L. 87-834, 76 Stat. 960. S. Rep. No. 1881, 87th Cong., 2d Sess., p. 11 (1962-3 Cum. Bull. 707, 717). To qualify for the credit (which is applied against the tax liability itself, thereby directly reducing such liability), the property must have a useful life of four years or more, and it must be personal property. Section 48(a).

Although the investment credit is primarily designed to encourage investment in new production facilities, a limited credit is available for used depreciable property which is newly acquired during the taxable year. However, no more than $50,000 of such property may qualify for the credit in any taxable year. Section 48(c)(1) and (2). Such a limited credit was considered necessary "because of the greater dependence of small business on used property" as a means of expanding productive facilities. H. Rep. No. 1447, 87th Cong., 2d Sess., p. 9 (1962-3 Cum. Bull. 405, 413.)

Section 48(c)(1) defines the term "used section 38 property" for the purposes of the investment credit. It specifically and unambiguously provides that, for purposes of the investment credit, "Property shall not be treated as 'used section 38 property' if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition * * *."

The property which taxpayers seek to qualify for the investment credit is clearly ineligible for such treatment under the narrow statutory definition of "used section 38 property." The property here was purchased in 1957 and used steadily by the taxpayers until 1962, when they sold it. They reacquired the property in 1963 and began using it again. Thus, the property in issue was being used by a person who used it before the acquisition, within the very language of Section 48(c)(1).

Taxpayers contend (Br. 10), however, that the relevant portion of the statute, quoted above, is ambiguous, and that it should be interpreted as if Congress had inserted the word "immediately" twice in the sentence, thus making it read as follows:

> Property shall not be treated as "used section 38 property" if, immediately after its acquisition by the taxpayer, it is used by a person who used such property immediately before such acquisition * * *.
> (Underlined words added by taxpayers.)

Taxpayers would then argue that since they did not use the reacquired property "immediately" before they acquired it by way of the foreclosure (i.e., they used it up to one year before the reacquisition), the statutory restriction would not apply to them.

Taxpayers' novel attempt to encourage this Court to invade the legislative province of Congress and alter the plain and direct language of a statute is unfounded as both a legal and historical proposition. See, e.g., 1 Mertens, Law of Federal Income Taxation (Rev. ed.), Sec. 3.02, p. 4, fn. 14: "meaning may not be interpolated where the statutory language is unequivocal and where liberal interpretation leads to no absurdity 'so gross as to shock the general moral or common sense,' see *Girard Inv. Co.* v. *Comm.*, 122 F 2d 843 (CCA 3rd, 1941)." Also see opinion of Justice Brandeis in *Iselin* v. *United States*, 270 U.S. 245 (1926). Taxpayers point to no ambiguity in the second portion of the above-quoted sentence. Instead, they merely claim that "if the word 'immediately' is to be implied as a modifier to 'after its acquisition,' it seems consistent that it might be implied as a modifier to 'before such acquisition as well'." (Br. 10.)

We see no reason, based in law or logic, for concluding that any portion of the statute implies the word "immediately." If Congress had intended to convey the idea of immediacy, it would have done so by including the word "immediately" in the statute itself, as it has done on many previous occasions. See, e.g., Section 351(a) of the Internal Revenue Code of 1954, "immediately after;" Section 355(a)(1)(A)(ii) of the Internal Revenue Code of 1954, "immediately before." There is no reason why it should have acted differently in connection with Section 48(c)(1).

Contrary to taxpayers' contentions, there is nothing in the Regulations which conflicts with the Commissioner's position here. As the Tax Court noted (I-R. 100):

> It [Treasury Regulations, Section 1.48-3] repeats the exact words of the statute with perhaps the qualification that property shall not be considered as used by a person before its acquisition if such property was used only on a 'casual' basis by such person. The latter qualification could hardly apply to petitioners for they used the property reacquired on April 4, 1963, from about December 4, 1957, to April 2, 1962, which would be more than a casual use.

Although an inquiry into the legislative history of the investment credit will lend further support to the Commissioner's position, this Court needs to go no further than the clear and definite wording of Section 48(c)(1) to affirm the decision of the Tax Court.

B. <u>The spirit of the statute, which is manifested in its legislative history and in the Regulations promulgated thereunder, supports a denial of the investment credit in the present situation</u>

The following reason was given by the House Ways and Means Committee for including the sentence in question here as part of the Section 48(c)(1) definition of used property (H. Rep. No. 1447, <u>supra</u>, p. 10 (1962-3 Cum. Bull. 405, 414)):

> To prevent abuse, however, there has been omitted from the term "used property," available for the credit that which is used by a person who used the property before such acquisition * * *.

The Committee Report then goes on to cite three examples where such an "abuse" might have existed, were it not for the narrow definition of used property which this sentence provides, and these examples are repeated in the Treasury Regulations on Income Tax, Section 1.48-3, Appendix, <u>infra</u>.

It may be that these three examples all involve situations where the person using the property after the acquisition happens to be the same person who used it immediately before the acquisition. Nevertheless, these examples do not, by any means, intend to illustrate the necessity for immediacy, but instead, show that the credit is not available where an asset acquisition does not result in the expansion or modernization of the user's productive facilities. Since the investment credit was enacted to promote economic growth (S. Rep. No. 1881, <u>supra</u>, p. 11 (1962-3 Cum. Bull. 707, 717)), it should not be available when an asset acquisition does not result in the economic growth and expansion of the user's productive facilities.

The sale and leaseback, the purchase by a lessee of the leased property, and the purchase by a lessor of property subject to a continuing lease (which are the three examples cited in the Committee Reports and in the Regulations) result in no actual economic growth, in no additional commitment by a producer to newly acquired assets. The investment credit is therefore not available in these situations.

If the rationale behind the Regulations is applied to the present situation, it becomes even clearer that the investment credit should not be permitted. Taxpayers committed funds for the purchase of the property in 1957 and used it in their business for five years. If the investment credit had been in effect at that time, it would have been available to them, since they had taken an action which the credit is designed to encourage; they had committed funds for the purchase of capital assets, thereby expanding their productive facilities. In 1963, however, when taxpayers reacquired the property to which $46,371.71 of their funds had remained committed over the years, they engaged in no activity which could be labeled an expansion or modernization of productive facilities. Having committed no new funds or additional credit to the acquisition of the assets in 1963, taxpayers should be denied use of the investment credit to prevent abuse.

The facts in this case reveal still another abuse involved in permitting the taxpayers an investment credit on the reacquired property. They committed funds to the property in 1957, when no investment credit was available. From 1957 through 1963, these same funds remained committed to this same property. The investment credit was enacted in 1962 and was to apply to "used property which is newly acquired" after December 31, 1961. H. Rep. No. 1447, _supra_, p. 9 (1962-3 Cum. Bull. 405, 413). The sale and subsequent foreclosure by taxpayers should not enable them to claim a credit which was designed to encourage _additional_ investment after December 31, 1961. Thus, the purpose of the statute as well as its clear language would be subverted if taxpayers were permitted an investment credit in the present case.

Taxpayers' argument based on the recapture Regulations (Br. 14-15) is not only a distortion of the legislative history of the statute, but is also the result of an inaccurate reading of those Regulations. Taxpayers contend that in each example provided by Treasury Regulations, Section 1.48-3(a), to illustrate the "abuse" which Section 48(c)(1) is designed to avoid, the investment credit is denied to the new owner because under Treasury Regulations, Sections 1.47-2(b)(2) and 1.47-3(g), both Appendix, _infra_, these precise fact situations present instances where there is no investment credit recapture by the Government from the original owner or user prior to the change of ownership. (i.e., the change of ownership is not considered a "disposition" or "cessation" of one's interest in Section 38 property.) According to the taxpayers, then, Section 48(c)(1) was enacted to prevent the possibility of two investment credits on the same property at the same time, by denying the credit to the purchaser.

To begin with, it should be noted that taxpayers are incorrect in their basic premise that the three examples in Section 1.48-3(a) of the Regulations each involve a situation where there is no recapture of the investment credit when the change in ownership occurs. In fact, one of the cases, that of the sale by a lessor who has not elected under Section 48(d) to treat his lessee as the investor to a purchaser who continues leasing to the same lessee, will result in a recapture of the investment credit by the lessor (according to Treasury Regulations, Section 1.47-2(b)(2), only if the election had been made, would there be no recapture), and a denial of the credit to the purchaser under Section 48(c)(1), because the property is being used by the same person before and after the sale. It follows that Section 48(c)(1) cannot be called a mere remedy for the recapture abuse.

As a historical proposition, taxpayers' recapture argument is especially deficient. They contend that Section 48(c)(1), which was enacted in 1962, was designed to correct a possible abuse created by Treasury Regulations, Section 1.47-2(b)(2) and Section 1.47-3(g), both of which were promulgated in 1967. It is immediately apparent that a prior statute could not have been intended to correct a subsequent Regulation.

Finally, taxpayers' assertion that the Commissioner's position is a deterrent to deferred payment sales is correct only to the extent that the investment credit recapture provisions act as a deterrent to all sales of Section 38 property before the expiration of their useful lives. Taxpayers, thus, rather inadvertently bring out the thrust of the Commissioner's position: the investment credit is meant to apply

to investment situations and not sale transactions. When a taxpayer invests in a depreciable asset and begins using it, he can claim an investment credit for that asset. Once having had the opportunity to take a credit for the investment in that asset, however, he may not sell it and buy it back and claim a second investment credit for the same asset. The second purchase is not considered an investment in "used section 38 property" under the plain and unambiguous language of Section 48(c)(1). */

CONCLUSION

For the above reasons, the Tax Court's decision should be affirmed.

Respectfully submitted,

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DECEMBER, 1968.

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*/ Taxpayers claim (Br. 5.) that at trial, the Commissioner's attorney admitted that they should have the investment credit available to them. No such admission was ever made, as a reading of the transcript will reveal, and the Tax Court's failure to find or even mention the existence of such an admission should be affirmed. When read in context, the sentence excised by taxpayers from the Transcript of the Tax Court proceedings indicates only that the Commissioner was willing to treat the repossession as a purchase for purposes of the investment credit, since he was treating it as a purchase for purposes of computing gain, and that it was not the intent of Congress to deny an investment credit in a repossession merely because it is technically not a purchase. (II-R. 7.)

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on petitioners appearing pro se by mailing four copies on this _______day of December, 1968, in an air mail envelope, with postage prepaid, properly addressed to them as follows:

Don R. and Mildred Thompson
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Suite 1000WR
Tucson, Arizona 85701

____
MITCHELL ROGOVIN
Assistant Attorney General

APPENDIX

Internal Revenue Code of 1954:

SEC. 38 [as added by Sec. 2, Revenue Act of 1962, P.L. 87-834, 76 Stat. 960]. INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.

(a) General Rule.--There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

*   *   *

(26 U.S.C. 1964 ed., Sec. 38.)

SEC. 46 [as added by Sec. 2, Revenue Act of 1962, supra]. AMOUNT OF CREDIT.

(a) Determination of Amount.--

(1) General rule.--The amount of the credit allowed by section 38 for the taxable year shall be equal to 7 percent of the qualified investment (as defined in subsection (c)).

*   *   *

(c) Qualified Investment.--

(1) In general.--For purposes of this subpart, the term "qualified investment" means, with respect to any taxable year, the aggregate of--

(A) the applicable percentage of the basis of each new section 38 property * * * plus

(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.

(2) Applicable percentage.--For purposes of paragraph (1), the applicable percentage for any property shall be determined under the following table:

If the useful life is--	The applicable percentage is--
4 years of more but less than 6 years....	33 1/3
6 years or more but less than 8 years....	66 2/3
8 years or more........................	100

*   *   *

(26 U.S.C. 1964 ed., Sec. 46.)

SEC. 47 [as added by Sec. 2, Revenue Act of 1962, <u>supra</u>]. CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY.

(a) <u>General Rule</u>.--Under regulations prescribed by the Secretary or his delegate--

(1) <u>Early disposition, etc</u>.--If during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

*　　　　　　*　　　　　　*

(26 U.S.C. 1964 ed., Sec. 47.)

SEC. 48 [as added by Sec. 2, Revenue Act of 1962, <u>supra</u>]. DEFINITIONS; SPECIAL RULES.

*　　　　　　*　　　　　　*

(c) <u>Used Section 38 Property</u>.--

(1) <u>In general</u>.--For purposes of this subpart, the term "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property. Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in section 179(d)(2)(A) and (B) to a person who used such property before such acquisition).

(a) <u>Dollar limitation</u>.--

(A) <u>In general</u>.--The cost of used section 38 property taken into account under section 46(c)(1)(B) for any taxable year shall not exceed $50,000. * * *

*　　　　　　*　　　　　　*

(26 U.S.C. 1964 ed., Sec. 48.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.47-2 "Disposition" and "cessation".

*   *   *

(b) Leased property--(1) In general. * * *

(2) Where lessor elects to treat lessee as purchaser. For purposes of paragraph (a) of § 1.47-1, if, under § 1.48-4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the following rules apply in determining whether such property is disposed of, or otherwise ceases to be section 38 property with respect to the lessee:

(i) Generally, a mere disposition by the lessor of property subject to a lease shall not be considered to be a disposition by the lessee.

*   *   *

(iii) If a lease is terminated and the property is transferred by the lessee to the lessor or to any other person, such transfer shall be considered to be a disposition by the lessee.

(iv) If the lessee actually purchases such property in the credit year or in a taxable year subsequent to the credit year, such purchase shall not be considered to be a disposition.

*   *   *

(26 C.F.R., Sec. 1.47-2.)

§ 1.47-3 Exceptions to the application of §1.47-1.

*   *   *

(g) Sale-and-leaseback transactions. Notwithstanding the provisions of §1.47-2, relating to "disposition" and "cessation", paragraph (a) of §1.47-1 shall not apply where section 38 property is disposed of and as part of the same transaction is leased back to the vendor even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his hands. * * *

(26 C.F.R., Sec. 1.47-3.)

§1.48-3 Used section 38 property.

(a) In general. (1) Section 48(c) provides that "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not "new section 38 property". * * *

(2)(i) Property shall not qualify as used section 38 property if, after its acquisition by the taxpayers, it is used by (a) a person who used such property before such acquisition, * * * Thus, for example, if property is used by a person and is later sold by him under a sale and lease-back arrangement, such property in the hands of the purchaser-lessor is not used section 38 property because the property, after its acquisition, is being used by the same person who used it before its acquisition. Similarly, where a lessee has been leasing property and subsequently purchases it (whether or not the lease contains an option to purchase), such property is not used section 38 property with respect to the purchaser because the property is being used by the same person who used it before its acquisition. In addition, if property owned by a lessor is sold subject to the lease, or is sold upon the termination of the lease, the property will not qualify as used section 38 property with respect to the purchaser if, after the purchase, the property is used by a person who used the property as a lessee before the purchase.

(ii) For purposes of applying subdivision (i) of this subparagraph * * * property shall not be considered as used by a person before its acquisition if such property was used only on a casual basis by such person.

*   *   *

(26 C.F.R., Sec. 1.48-3.)